United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

ORIGINAL

74-1694

To be argued by
LAWRENCE M. POWERS

United States Court of Appeals
FOR THE SECOND CIRCUIT

TITAN GROUP, INC.,

Plaintiff-Appellant,

against

HAROLD FAGGEN,

Defendant-Appellee.

REPLY BRIEF FOR APPELLANT

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REPLY BRIEF FOR APPELLANT

1. The tax returns referred to in the contracts are irrelevant to a claim of fraud in the pro-forma earnings statement supplied by Mr. Faggen.

The Brief for Appellee Faggen fastens on the acquisition contract to argue that since only tax returns from Faggen were exhibits to the contract, Appellant Titan is therefore foreclosed from proving fraudulent omissions in the pro-forma earnings summary supplied by Faggen during negotiations, which increased tax return earnings up to $571,000 in 1968. This argument was even rejected by the Court below, saying to Titan "the case law supports [you]," for fraud in inducing a contract opens the door to the essential business "sales talk" used to induce the transaction (1097). "No form of contract can stand, if induced by fraud." *Arnold* v. *National Aniline & Chemical Co.,* 20 F. 2d 364, 369 (2d Cir., 1927, Hand, A.). Misleading unaudited financial presentations with unexplained adjustments are a recurring form of misrepresentation under the federal securities laws as well as the common law. *Norte & Co.* v. *Huffines,* 304 F. Supp. 1096, 1103 (S.D.N.Y. 1968), affd. *in rel. part.* 416 F. 2d 1189 (2d Cir. 1969). Fraud vitiates any contract despite provisions that all understandings are merged therein, that an investigation has been made, that there was no reliance on any representation or exhibit not in the agreement, or that complaint must be made within a specified time period. *Rizzi* v. *Sussman,* 195 N.Y.S. 2d 672 (A.D. 2d, 1959); *Massler* v. *Smit,* 111 N.Y.S. 2d 264 (A.D. 2d, 1952). No contract can grant immunity from fraud in its inducement, *Sabo* v. *Delman,* 3 N. Y. 2d 155 (1957); *Carlinger* v. *Carlinger,* 249 N.Y.S. 2d 760 (A.D. 1st, 1964). Section 29(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78 cc(b)) expands upon this common law principle. "The statute would be of little value unless a party to the contract could apply to the Courts to relieve himself of obligations under it or to escape its conse-

quences." *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa., 1946). *Bromberg on Rule 10b-5*, pp. 31-32, and *Loss on Securities Registration*, p. 1757, ground the whole field of civil liability under Rule 10b-5 on this principle, that the presence or absence of an exhibit or of a representation, or any other acquisition contract "boiler-plate," cannot foreclose a fraud inquiry which searches the record. See *Rogen* v. *Ilikon Corp.*, 361 F. 2d 260 (1st Cir., 1966); *Schine* v. *Schine*, 254 F. Supp. 986 (S.D.N.Y., 1966); and *Bankers Life and Casualty Co.* v. *Bellanca Corp.*, 288 F. 2d 784 (7th Cir., 1961). Thus Faggen cannot escape the impact of his pro-forma earnings presentation which was the sales tool to effect the transaction, merely because cash basis tax returns, instead of real financial statements were part of the contracts. Even the contractual "boilerplate," although irrelevant, picks up selling material; section 3.23 says: "*Material Misstatements or Omissions.* No . . . document, statement, certificate or schedule furnished to Titan . . . in connection with the transactions contemplated hereby, contains . . . any untrue statement of a material fact necessary to make the statements or facts contained therein not misleading" (1638). The Diebold memo, the selling memo and the 10-year projection (see p. 15, 12, 19 of Brief for Appellant, "T. Br.") are certainly "documents," "statements" or "schedules" furnished to Titan "in connection with" its acquisition transaction, and all three state $570,000 in pro-forma income for the year of acquisition. But this is not a suit on the contract, but rather, for fraud in its inducement. The contract provisions cannot foreclose intensive analysis of the selling memo and its documentary relatives.

2. The pro-forma summary of adjusted earnings is subject to the same general principles of accounting as any other presentation of earnings.

Faggen's brief ("F. Br.") characterizes the selling memo as an "informal presentation of adjusted earnings," later

calls it a "summary prepared in accordance with appellant's instructions," and finally, warming up to his ultimate argument, says "The summary was not and could not have been a financial statement" (p. 2, 15, 39 F. Br.).* The purpose in trying to reduce Faggen's detailed presentation of four years of adjusted earnings to just a troublesome scrap of paper is somehow to establish that accountant Faggen was not subject to the rules of disclosure that bind other accountants when he prepared the selling memo. The issue is simply, did the pro-forma earnings summary of the selling memo (p. 12, T. Br.) require further explanation in accordance with generally accepted accounting principles? Titan does not urge that all the accounting rules of the S.E.C. and Regulation S-X applied to these pro-forma summaries, but only generally accepted principles, those which are the same for all financial statements—as enunciated by the Accounting Principles Board, whether filed with the S.E.C. or not. Faggen argues from *Bresnick* v. *Home Title Guaranty Co.,* 175 F. Supp. 723 (S.D.N.Y., 1959) that S.E.C. proxy rules did not (in 1959) apply in their entirety to an over-the-counter company, and similarly S.E.C. accounting rules did not apply to the earnings summary he delivered to Titan. But in *Bresnick* more general disclosure and fraud concepts *were* treated as applicable.

The accounting principles discussed at pages 14-31 of T. Br. are required under rules of fairness—whether S.E.C. rules or general accounting rules—because they are basic to full disclosure. Their substance is embodied in a single concept applicable both to accounting statements and se-

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* The absence of sales and details of expenses did not prevent it from being an earnings summary, and sales were already well known and discussed by the Titan board (1344, 975, 1382, 390-391). Such items are often left out of earnings summaries, and were irrelevant detail to a buyer concerned with the growth pattern of four years earnings.

curities transactions generally—materiality. The accounting literature says: "Information should be disclosed in financial statements when it is likely to influence the economic decisions of the users of financial statements. Information that meets this requirement is material . . . the stress is upon *likely to influence decisions.*" *The C.P.A. Journal, "Factors Affecting The Materiality Judgment,"* July 1974, p. 39. The same concept is in *Republic Technology Fund, Inc.* v. *The Lionel Corp.,* 483 F. 2d 540 (2d Cir., 1973)—disclose the bitter with the sweet, avoid misleading inferences by a full explanation, and do not create earnings out of non-realizable or non-recurring items. See *Value Line Fund* v. *Marcus,* CCH Fed. Sec. L. Rep. 1964-66, ¶ 91,523, sought to be distinguished by saying no formal contract existed there, only a purchase confirmation; but the accounting inquiry there, involved deceptive earnings presented much like those herein. *Herzfeld* v. *Laventhol, Krekstein, Horvath & Horvath,* CCH Fed. Sec. L. Rep. ¶ 94,574, at p. 95,999 (S.D.N.Y., May 29, 1974), invokes an even stricter rule than is required herein: "In those cases where application of generally accepted accounting principles fulfills the duty of full and fair disclosure, the accountant need go no further. But if application of accounting principles alone will not adequately inform investors, accountants, as well as insiders [Faggen held both positions], must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately." The Rule 10b-5 concept of materiality is identical to that quoted above from the C.P.A. Journal, "the report was *materially* misleading . . . [because] the facts which Laventhol failed to disclose . . . are facts which affect the probable future of the company and . . . which may affect the desire of investors to buy, sell or hold the company's securities." *Herzfeld, supra,* at p. 96,002. To illustrate the fundamental nature of the selling memo's omissions,

if the law were complied with, the adjusted earnings would have said (p. 12, T. Br.):

"Net Income—Pre-Tax . . . [adjusted]

	1965	1966	1967	1968
Harold Faggen Associates, Inc. (June 30)	$253,357	$367,087	$332,192	$430,596
Actuarial Tabulating Corp. (March 31)	59,878	60,976	59,201	65,806
Employee Fund Services Corp. (Sept. 30)	32,767	27,891	25,252	29,104
Harold Faggen, Personal (Dec. 31)	34,800	34,800	35,240	35,280
Totals	$380,802	$490,754	$451,885	$571,262"

The schedule should have gone on to say: "The foregoing adjusted totals for pre-tax earnings for 1965-1968 'adjusted to basis to prevail after acquisition' were derived by taking taxable income for the four years, and adding thereto certain increments. These additions to income (which supersede the Diebold memo previously furnished) consisted of taxes paid to state and city governments, assumed salary savings by limiting Harold Faggen to $50,000 by 5-year contract, and several other annual adjustments described below. The magnitude of the adjustments are:

	1965	1966	1967	1968
Net Income, as per Tax Returns	—	—	—	$350,008
Total Amount of Annual Adjustments	—	—	—	$221,254

A. The adjusted earnings shown include significant investment income for each of the four years, which was not earned from actuarial business operations. This investment income was: 1965—$36,377, 1966—$78,752, 1967—$36,377, and 1968—$51,777, resulting from transactions in securities, dividends and interest, not realizable if the securities portfolio is liquidated.

B. The adjusted earnings include an assumed addition to income for each of the four years representing prior pension plan contributions, believed unnecessary because the pension plan has been overfunded. The pension plan contributions added back into earnings shown are $ for 1965, $ for 1966, $ for 1967, and $64,556 for 1968 [Faggen has never suppl ed the amounts he used for these earlier years]. These assumed earnings increases are non-recurring in nature, because pension contributions 1965-1968 ranged from $21,000 to $69,000 annually. There can be no assurance that additional contributions will not hereafter be required in comparable amounts, and no actuarial study has been made to support this adjustment. Furthermore, the assumed "earnings" for 1965-1968 are not funds available in the business and do not increase net worth, as would actual earnings, because they cannot be obtained without terminating the plan and distributing their shares to covered employees, with no further pension coverage provided.

C. The earnings shown were determined without giving effect to any type of negative accrual adjustments which may be required, and specifically, do not give effect to vacation plan benefits accrued for 1965-1968 in the sum of $59,000, which are a charge against earnings during such period, and will be a recurring future charge against earnings.

D. The earnings shown give effect to a $ addition in 1965, and $ in 1966, $ in 1967, and $10,000 in 1968 [Faggen has never supplied these other amounts] assumed to result from a reduction in Rose Dogan [Faggen's] annual salary from $50,000 to $40,000. There is no employment contract in effect or contemplated, controlling the amount of her salary, however, and it is subject to increase at the discretion of Mr. Faggen as chief executive operating the Faggen companies. The continuity of such earnings in future years is not determinable. [Her salary increased 1969-1972, from $50,000 to $71,000.]

E. The earnings shown give effect to assumed "earnings" of $37,574 in 1968 from total savings on Mr. Faggen's expense accounts ($), automobiles ($), personal apartment ($), boat ($), legal fees ($), and other personal (?) items ($) which will be eliminated after the acquisition, and totals of $ for 1967, $ for 1966 and $ for 1965 similarly added to income [Faggen has never supplied any of these figures] for such expense items. The future increments to earnings from such savings are not determinable, because there is no assurance that all of these expense items can be saved in future years, or that Mr. Faggen will not replace them by other or greater expense items.

F. If each adjustment A, B, D and E is not maintained in full force and effect after acquisition, the $571,262 in pro-forma earnings for 1968 would not exist or thereafter be attainable, with a related negative effect for 1965-1967. Adjusted earnings, inclusive of, and then net of items A through E are:

	1965	1966	1967	1968
Adjusted Totals	$380,802	$490,754	$451,885	$571,262
Net Totals	261,310	303,339	336,395	403,721
Differential*	119,492	187,415	115,000	167,541

The disclosures required indicate why Mr. Faggen, a practicing C.P.A., did not comply with the rules. The principles cited apply to audited or unaudited statements, complete earnings statements or summaries, and accrual or cash basis or pro-forma earnings statements. The dichotomy here is not between regular accounting and S.E.C. accounting, but between illusion and reality. Titan was prepared to pay 10 times pre-tax earnings, $5.5 million in notes were available, Fagen had used the Diebold memo on Kaufman showing $571,000 to justify it, and he now had to work backwards to come up with the 4-year numbers

* See p. 21, T. Br. on such overstatements of earnings.

he needed for the selling memo. He was "cooking the books", but could not risk disclosing all the details of his recipe, and thereby painted a misleading picture. His summary of earnings "absent disclosure of the reasoning and facts which prompted it, would not alert potential investors to the uncertainties [he] . . . knew were lurking in the . . . [series of adjustments]." *Herzfeld, supra,* at p. 96,003. Notes A through F also convey why this is primarily a non-disclosure case—it is the deliberate omissions which embody the deception.

Faggen twists facts (p. 26, F. Br.) to avoid fundamentals. E.g. the accounting principle is that investment income, as non-operating income, had to be separately disclosed—and it was in the superseded Diebold memo ("deduct investment income"), it was then not mentioned in the selling memo, but then separately disclosed in the 10-year projection (p. 19, T. Br.). Fagen says "there was no writing that specifically stated that investment income was not included" in the selling memo. But it was his duty to identify this fancy footwork, not Titan's to decipher it. Faggen then says, "Appellant never proved that . . . [the selling memo] was derived from the Diebold Memo." But if both showed $571,000 in adjusted earnings for 1968, it was Faggen's duty to disclose that the selling memo was not derived from the one given Kaufman four weeks earlier; the law implied a duty to distinguish them, if separately derived. Or he says (p. 24, F. Br.) there is no evidence Kaufman told Frank about the figures in the Diebold memo when they joined with Faggen at the second meeting—is Faggen arguing that he could play off one negotiator's knowledge against assumed gaps in the other's? This kind of "double think" permeates the F. Br., p. 25), "It was not appellee's responsibility to determine the scope or extent of McIntyre's investigation." In other words, if accountant McIntyre believed accountant Faggen's general, verbal explanations of the 1968 adjustments (1469-1470), so reported to Frank, accepted Faggen's refusal of a Peat, Marwick audit (a "competitor"),

and assumed Faggen could support his precise adjustments with valid figures for four years, then Faggen can escape the "A, B, C's" of disclosure accounting. Faggen's argument reduces itself to "What fools you were to believe me!" And as shown, it is not McIntyre, but Titan's public stockholders and other creditors who are being made the fools. Another argument (p. 27, F. Br.) is similar—if excess net worth of $1 to $1.3 million was not being paid for separately, that apparently justified seeking a ten times payment for its income yield each year by surreptitiously adding it to reach adjusted earnings of $571,000. He gave up the multiple on 12% of net earnings in his negotiations, but retrieved it by reaching the same total another way. But Titan "expected net worth to be part of the package . . . of ten times . . . operating income" (134, 123), and the accounting principle leaves it up to the buyer to weigh, *after full disclosure,* not to after-the-fact arguments justifying it by the seller of securities.

Another irrelevant contention by Faggen's Brief is the attack on accountant witness Rohn's credibility (p. 29, 40-42).* This case rests on omissions from Faggen's writings, his post-litigation explanation of his undisclosed adjustments (483A # 73-1345), exact in amount for 1968, and disclosure principles as to each item. Belief or disbelief in Rohn, the Touche, Ross partner, is irrelevant. But the attack concedes that it cost $19,000 to fund the pension plan in 1971, that costs and employees covered were increasing (foreseeable under Faggen's computer expansion plans) and that its claimed excess assets were locked up in a separate balance sheet, unreachable without going out of business, demonstrating the need for complete explanation

* The attack is without substance in its key point—Titan's accrual basis reconstruction for 1965-68 was supported by four accounting professionals (539, 648, 675 and 785), with no contrary testimony, notwithstanding Faggen's misquote of the record (647-648). There was also no "shift of ground" between the complaint and the trial, as urged (p. 15, F. Br.). Faggen's Diebold memo and the selling memo both used accrual concepts to restate reportable income to Titan.

of this income adjustment. Faggen says the $64,556 pension increment still "would have allowed for . . . as much as $49,000," taking the smallest side of the 1972 estimated $15,000 to $30,000 in continuing annual pension cost of doing business. Would it have provided $34,000 to $49,000 in extra income for the next ten years? And wasn't Titan entitled to know the possible variance, when paying ten times for each earnings dollar? Or that there was not even an actuarial study in 1968 to support actuarial consultant Faggen's blithe assumptions of savings? Faggen also dispenses with his overlooked negative adjustment for $59,000 in vacation pay (disclosed at the closing but never incorporated into the adjusted income representations) by saying it was "an accrual item and Exhibit 2 only dealt with cash adjustments." In other words, "I can mislead you by leaving out charges against income because orally I made the general distinction somewhere that I was just talking about cash basis adjustments to earnings." Where does the selling memo distinguish between cash basis and accrual basis, or plainly exclude negative adjustments?

Faggen's silence on the illusory quality of Rose Dogan's salary decrease (p. 30, F. Br.), is answered by his misstating the record. His reference to 393A # 73-1345 is not to a contractual ceiling on salary for five years, but only to a list of employees and salaries being paid, as a descriptive exhibit to the contracts. There might have been a saving if she had been subject to a contract, or even if Faggen had disclosed that this was a specific adjustment relied upon and Titan must police his management decisions to make sure he didn't give it back to the next Mrs. Faggen. Instead of savings, Mrs. Faggen received several increases from Mr. Faggen (p. 28, T. Br.), thus decreasing the adjusted earnings. The adjustment for travel, entertainment and other expense savings of exactly $37,574 (note his precision 481A #73-1345) are defended by saying "the parties agreed after discussion on October 2nd" as to that amount. Where is the agreement? There is no finding of fact or law as to any agreement, and also no evidence of any.

3. There are no genuine factual disputes underlying the essential legal issues of this case.

The factual concessions of the F. Br. overpower trivial distinctions, e.g., he says the selling memo was "handwritten . . . two months before the execution of definitive contracts," (p. 2), but Faggen gave his neatly prepared memo to Frank and Robinson to be typed up and received a typed copy back. And this write-up was requested of Faggen on October 2nd, the day the transaction was definitely agreed upon. Faggen demanded the contracts be effective "as of October 1, 1968" (60A # 73-1345) and that interest be paid from the date of this handshake, when the request was made of him for a write-up of what he had said (42, 43, 140-141). Kaufman knew the figures going into the selling memo (p. 51, T. Br.), contradicting F. Br. (p. 9*) that Kaufman didn't know about the presentation until this lawsuit was started.* Is Mr. Faggen urging that Frank and Kaufman (with Robinson participating) asked for this write-up, "appropriate materials . . . for submission to the board" (140-141), as a mere idle gesture?

Faggen's emphasis on a 1969 Titan proxy statement saying it had bought his companies in arms-length negotiations, after investigation, is misplaced, as is the claim of estoppel by its confirming the validity of the notes for Faggen's first wife to Faggen's lawyers (Robinson's firm) in 1970. The corporation's officers believed they had negotiated at arms-length with full and fair disclosures—their statements in the 1969 proxy statement confirm that. There was no claim of fraud to anyone until 1971-1972. Public reports of Titan did not reflect the fraud claim and its necessary effect on the excess purchase price paid over asset value (see p. 42

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* A memo (Frank to Kaufman) of October 7, 1968 describes the write-up in preparation (1379, 141). Faggen's unsupported attack on Kaufman's credibility because he had a dispute with Titan in 1971 is irrelevant, because there can be no dispute on the documents from Kaufman's files—the Diebold memo and 1968 tax returns, the notes of conversations with Faggen and the draft public announcement, reflecting over $550,000 in operating earnings.

F. Br.) until suit in 1972, when Titan fully disclosed its claims of inadequate value which also affected the $5.5 liability owed (948, 952). Titan's belief that it was acquiring more than $550,000 in reportable "operating income" recur in the October, 1968 draft announcement of the transaction (1381), the quoted recollections of all the executives involved and nearly all directors, and in three memos furnished by Faggen at the time—the selling memo, the Diebold memo, and the ten-year projection (see p. 19, T. Br.). Faggen tries to erase the contemporaneousness of this handwritten, ten-year projection, subpoenaed from Robinson's personal negotiation files. Faggen admits he alone prepared it, but only when "I went to Ben Robinson to discuss what I considered to be a problem after the closing." (998) The document projecting $570,000 from 1969 forward speaks as of the end of 1968, and is legally contemporaneous with the selling memo written October 7, 1968, and the Diebold memo furnished September 2, 1968. There is no contrary finding of fact. Frank plainly remembered reviewing the 10 year projection during the period that the negotiations were in progress (280-282, 299). Even if, *arguendo,* the negotiations were already closed for a few days or weeks, the $570,000 in operating income shown still ties directly into the selling memo and the Diebold memo, and reflects the adjusted earnings held out. Again, Mr. Faggen cannot peel the flypaper saying $570,000 from his fingers.

Faggen's repetitive argument that this suit was brought from "base motives" was rejected even below, see (1189-1190) where the District Court said these claims were not frivolous but had to be decided, and such argument is also irrelevant, as are the angry reactions in 1971 by other shareholder-directors aroused by Faggen's overreaching. The facts plainly reflect no questioning of the transaction until 1971, with Robinson and Faggen the only two Titan directors with any continuity, and no hard evidence of fraud until the 1972 audit. The Court below did not find laches or any statute of limitations bar to this action. Faggen was

entirely in control of his division from 1968 through 1972, still avoiding outside auditors claimed to be potential competitors.

A. *Who Wrote the Pro-Forma Presentations?* The tack taken by Faggen is to place responsibility for the documentary trail of inflated earnings on Titan's executives rather than on himself as author of the three documents. But the record does not support the claimed "explanations" and joint draftsmanship. Faggen says (p. 6, F. Br.) "items . . . were questioned by Kaufman and appellee agreed that some of its [Diebold memo] underlying assumptions were inappropriate, particularly . . . accrual adjustments to cash basis tax returns." (59). But except for this inconsequential distinction between cash and accrual basis adjustments, the Diebold memo was an entirely unexplained presentation drawn by Faggen, who testified—"Q. And you didn't have any discussion as to the adjustments which were contained in Exhibit 1-A [Diebold memo], did you? A. I don't recall specific discussions. Mr. Kaufman looked at it . . . Q. Now, did you discuss these adjustments with Kaufman again at your meeting on October 2? A. We never discussed them. Q. You never explained anything in those adjustments to Kaufman? A. No." (59) Faggen next tries to make Kaufman and Frank joint authors of the selling memo four weeks later, saying, "they hypothesized a series of changes to the net income . . . shown on the tax returns . . . They thus translated the earnings . . . had appellant, a public company, then owned them." (pp. 6-7, F. Br.). But a public company cannot report non-operating income from investments or non-recurring income without separately identifying it, nor unobtainable "income" from artificial adjustments, nor ignore negative items. Kaufman and Frank could not be assumed to have "satisfied themselves" or "agreed" to adjustments which were unreal. Moreover where are the claimed "agreements"—they certainly don't appear in the record. Again, Faggen's reference (975 et seq.) shows these were entirely Faggen's adjustments; "Mr. Kaufman . . . asked me . . . which adjustments I had in mind . . . I told him that I con-

templated the following adjustments . . ." (975-976). And even if, *arguendo,* Frank and Kaufman said "yes, that sounds logical," they were necessarily dependent for each detailed adjustment upon Faggen's completeness and candor.

The last piece of equipment dropped by Faggen on his trail is the ten-year projection (p. 19, T. Br.). Faggen says "it was never discussed with or shown to the Board of Directors." His testimony was: "Mr. Faggen, who asked you to prepare Exhibit 8 [the 10-year Projection]? A. Nobody. Q. You prepared it yourself? A. That is correct. Q. And you supplied it to [Chairman] Ben Robinson? A. I went to Ben Robinson to discuss what I considered to be a problem after the closing. Q. I didn't ask you that, and I move to strike that last part. Mr. Faggen, on Exhibit 8 you made a distinction between $570,000 in operating income and investment income, didn't you, for 1969? A. For 1969 on Exhibit 8. Q. You made that distinction, didn't you? A. Yes, I made many assumptions on Exhibit 8 and distinctions." (998) Director Anthony Frank said: "A. I believe it was shown to me by Mr. Robinson . . . I believe it was prior to the board meeting that approved the acquisition . . . (280) . . . I recall, your honor, being told by Mr. Robinson that it was prepared by Mr. Faggen." (282) The key point is that Faggen concedes he wrote it *alone*—not with helpers. And it shows how Faggen was selling himself—$570,000 in operating income, plus additional investment income, and 15% annual future growth (5% annually from [143] existing clients, and 10% annually from new clients, p. 19, T. Br.). There are no findings below on this business representation that led Frank to a Board presentation, "using for those specifics [of the transaction] the Exhibit 3 [the selling memo]" (283, 285), which contained the same essential representations.

B. *The Concession That More Than $500,000 Was Expected.* Faggen's brief has also conceded Titan's reliance

on earnings higher than on his tax returns. Kaufman and Frank satisfied themselves that "... Earnings would have been in excess of $500,000 in 1968 ... Appellee assented to Kaufman's terms and they shook hands on the deal." (p. 9, F. Br.) See Faggen's cited, self-serving, testimony—"Kaufman said that, 'We are satisfied with the figures, they certainly come up to what we had expected, to what Mr. Frank had told them I had said that on an adjusted basis it would be approximately half a million dollars,' it was well over that according to his calculations, and he made his offer." (980-981)

If the Court concludes Faggen's claimed $500,000 reliance amount had $52,000 in undisclosed 1968 investment income in it—as Faggen repeatedly concedes it did (p. 26, F. Br.)—this was a material omission of fair disclosure, a 10% item in 1968 and 8% to 18% in the three earlier years, increasing as other adjustments evaporate. And even if it were only half as much, its clear exclusion from the Diebold memo and the 10-year projection involved a *material change in concept* and required plain disclosure in the selling memo. If the Court concludes that $64,000 in pension "savings" concededly included in the $500,000 was not properly disclosed or was offset by the undisclosed $59,000 *negative* vacation plan adjustments, $64,000 or even half that, is a material overstatement. A 5% income item is material in an earnings summary (p. 22, 30, T. Br.), particularly when it is being sold at ten times pre-tax earnings. If the particular items, concededly (980) unspecified for the full four-year period portrayed a growth curve that was unreal, because reality was well below $500,000, Rule 10b-5 was violated. This distorted growth curve is perhaps the most fundamental omission in the case, and his ten year projection is Faggen's signature on the distorted portrait of the past.

C. *No Issue On Clients Lost.* There is silence in the F. Br. on the number and amount of clients lost in 1968,

and undisclosed before the deal was closed—12 clients, $103,500 in billings (10% of gross business), including the biggest single client, the Carpenters Union. The undisclosed potential loss of some $90,000 in related clients, clients known to be merging out of existence, or under investigation is also not contested. Faggen's only answer is that Kaufman and Frank could have looked through his voluminous ledgers for lost clients. *Stier* v. *Smith,* 473 F. 2d 1205, 1208 (5th Cir., 1973), and *Dale* v. *Rosenfeld,* 229 F. 2d 855, 858 (2d Cir., 1956) say "Availability elsewhere of truthful information cannot excuse untruths or misleading omissions," and "readiness and willingness to disclose are not equivalent to disclosure." (See p. 36, T. Br.). Faggen argues that Titan did not complain about lost clientele. It had no basis to complain until the executives who replaced Faggen in 1972 alerted Titan to past client shrinkage. The additional $109,000 Tabor defection (difficult now to accept as unforeseeable in light of an undisclosed similar defection early in 1968 (752)) was made to appear in early 1969 as a favorable event—"Mr. Faggen told me [Kaufman] these clients were really not all that important . . . that the clients that they took with them were marginal accounts, which weren't really profitable . . . and that the lawsuit would likely be more profitable." (164) The cumulative effect of this loss of earning power could not be seen when the earlier loss of $103,500 in billings was unknown and the foreseeable loss of another $90,000 in eroding clients was still unknown.

D. *Faggen Gives The Game Away.* F. Br. (p. 35) sets up a table to show that the actuarial business sold continued "to generate substantial profits until . . . 1972," separating the large losses from computer operations, to examine actuarial earnings (often from the same clients) in isolation. But the table in fact reveals Faggen's deception in holding out actuarial earning power of $570,000, by any kind of adjustments.

(1) For 1969 he shows $398,000 in earnings—a 25% exaggeration of reality even for Faggen's conceded $500,000. Moreover, in 1969, these $398,000 in actuarial earnings include a one time payment of $250,000 for the clients taken away by Tabor. Kaufman testified, without contradiction, ". . . the actuarial operations, as I recall, received a substantial amount in payment in settlement of that transaction [litigation], and some of that, if not all of that, payment was taken into income during '69 and to some extent made the drop in earnings less precipitous." (169) Even now Faggen is still treating $250,000 of non-recurring extraordinary income as equal to operating income.

(2) For 1970, Faggen shows $476,000 in actuarial earnings, which two years later is still $100,000 short of the $570,000 represented, and $169,000 short of the $645,000 projected for 1970 in his 15% growth plan in the ten-year projection. But even this shortfall is understated because a major new client was obtained—(witness Castrovinci) "Q. Was the actuarial business staying at a level or was it shrinking or was it getting larger? A. . . . By volume, I think I have already testified that this one major client made up for a great portion of the volume, however, there was shrinkage in the amount of clients that we had." (818) Titan did not pay a 20-times after-tax multiple—a rapid growth valuation—in order to stand still. Faggen said pre-tax growth was and would be 15% a year (p. 39, 19, T. Br.). The Faggen companies, with the windfall of a litigation, and the fortunate acquisition of a large new client, were still short of the mark. The basic earning power represented was never there to begin with, and fortuitous events concealed the degree of shortfall from $570,000.

(3) F. Br. (p. 35) completes the story—$328,000 in actuarial profits in 1971—this apparently represents normality in the Faggen operation and is remarkably close to the $365,000 in pre-tax income shown on his 1968 tax returns

reducible by $52,000 in investment income, to an operating net of $313,000. He corroborates this by boasting of "income in excess of $350,000 before and after the closing." (p. 51, F. Br.) Net earning power from actuarial operations was thus $313,000 in 1968, and in 1971 it was about the same, $328,000. *His own figures tell the tale.* Everything in between was a lot of artificial accounting legerdemain, practiced by a master of non-disclosure.

The computer operations, started and managed by Faggen caused the large losses he concedes (p. 35, F. Br.) which offset his real actuarial earning power of $328,000 and reduced it to a net of $136,000 by 1971 and a substantial net loss by 1972. His incapacity in computers led to "an acute problem during '70, '71, at that point . . . It [the computer operation] was strangling the business from two points of view, from a monetary point of view, and secondly from the animosity I [witness Castrovinci] felt it created with our actuarial clients because if you screw up their data processing records they are going to figure, well, you are not a good actuary." (812-813) All the artificial fragmenting of Faggen's basic business representations cannot conceal the totality of what he said he had to sell, and what he actually had to sell. The District Court, with due respect, was so bemused with telling plaintiff how absurd its contentions were about lost clients, and the "irrelevance" of post transaction loss of earnings, that it missed the connecting links entirely. The whole selling memo hangs together as a tissue of lies—the adjusted earnings weren't real, they were just accounting tricks; the growth trend was imaginary, the clients were shrinking; and Faggen didn't know anything about the computer business he was going into, and selling with such enthusiasm. His factual concessions at trial, but now pulled together in a table with such devastating clarity (F. Br. p. 35) show the relationship between each non-disclosure. A business earning $313,000 annually from 1968 operations was losing some important clients and going into a costly new com-

puter operation with one programmer and a good salesman (Faggen) to attract clients. By blowing up each business element with his accounting ploys and writing up three misleading memos, Faggen made the acquisition sale for $5.5 million in Notes, 18-times pre-tax earnings instead of the agreed 10-times earnings. Three years later, the original business was still earning $328,000 *with all the "adjustments" in effect;* it was not even standing still, having partially made up for the lost clients by a lucky litigation recovery and one big new client, but the computer operations were strangling it. The finding that the actuarial business "continued to do a strong business" is wide of the mark—$328,000 is not $570,000. Titan bought earning power that was never there.

E. *Reliance.* Faggen argues that *Affiliated Ute Citizens* v. *U.S.* and *Shapiro* v. *Merrill Lynch, etc.* (cited and quoted 44-45, T. Br.) do not apply because this is not really an "omissions" case, and even if it is, a face-to-face acquisition transaction still requires proof of reliance.

The selling memo is deficient primarily by what it left out about "adjustments," clients, etc., not by what it said that was false. So Faggen argues that the specific representations of the contracts supplant any claim of general reliance upon fullness of disclosure. But that is, effectively, making the contracts a bar to proving a Rule 10b-5 or common law fraud case. "No form of contract can stand, if induced by fraud." *Arnold* v. *National Aniline & Chemical Co., supra.* Faggen's argument (without a single authority in point) is an attempt to press the contracts and their "boilerplate" into a controlling position in this case through the back door. *Affiliated Ute* and its progeny simply foreclose the need to prove reliance in a case primarily involving non-disclosure, and that principle cannot be overcome by re-invoking the contracts. Mr. Faggen then invokes *Chris-Craft Industries* v. *Piper Aircraft Corp.*, 480 F. 2d 341 (2d Cir., 1973) to argue that *Affiliated Ute* does not eliminate proof of reliance in face-to-face

transactions. The authority does not state that, and the page citation (p. 47, F. Br.) is in error. In any event, *Ute* itself was a face-to-face transaction, as it was so described in the recent *Shapiro* v. *Merrill Lynch* opinion (see quote, p. 45, T. Br.). The other cases cited also do not support Faggen. *S.E.C.* v. *Lums, Inc.,* 365 F. Supp. 1046, 1059 (S.D.N.Y., 1973) affirms that in private non-disclosure cases materiality is a principle of "constructive reliance." *Landy* v. *F. D. I. C.,* 486 F. 2d 139, 170 (3rd Cir., 1973) did not involve omissions, and held "the presumption of reliance sometimes used in other circumstances when a statement is material is inapplicable." A recent authority on "constructive reliance" supporting Titan is *Barthe* v. *Rizzo,* CCH Sec. L. Rep. ¶ 94,711 (S.D.N.Y., July 26, 1974), "Rizzo defends these actions by proclaiming that 'Barthe was not interested in full disclosure—he was not even interested in minimum disclosure.' . . . That argument ignores the purpose of the securities laws [citing *Affiliated Ute*] . . . [which] substitute a philosophy of full disclosure for the philosophy of caveat emptor . . . *This basic purpose is no less pertinent in purely private transactions* . . . [he] is not excused from his duty to disclose . . . because the client was not sufficiently suspicious to think of asking . . ." (p. 96,461-96,462, emph. supp.).

Turning to the proof of reliance, Faggen argues there was an affirmative duty to investigate here, citing *Evans & Co.* v. *McAlpin,* 434 F. 2d 100, 104 (5th Cir., 1970). But that decision simply says that reasonable diligence was relevant to a jury instruction where the claimed wrongdoer in complex securities trades had his checks dishonored for insufficient funds for months, but the brokers continued to accept checks instead of freezing the accounts as federal reserve rules required, and then claimed fraud when later checks were dishonored. Titan plainly did investigate Faggen's representations by asking for the selling memo, questioning him about the items, and then relying on his answers and high standing as a meticulous accountant. Faggen urges

that a seller can omit disclosures to a sophisticated buyer of securities with impunity. There was no one in Titan who had Faggen's detailed personal knowledge of each adjustment being set down. But assuming sophistication, *Stier* v. *Smith, supra,* states that such buyers, like anyone else, are also entitled to the truth. See *Lehigh Valley Trust Company* v. *Central National Bank of Jacksonville,* 409 F. 2d 989 (5th Cir., 1969), where a commercial bank induced several other banks to join in a line of credit to a motel company, without disclosing deteriorating operations affecting the value of the assets securing the loan. Faggen's argument ignores the special trust that sophisticated accountants place in each other's specific factual statements and precise summaries of adjusted earnings. Titan's former in-house accountant McIntyre questioned Faggen and was satisfied that there was more than $550,000 in adjusted earnings. Accountant Faggen had a duty to inform him of any questionable assumptions. F. Br. (p. 26) says McIntyre recalled "that investment income was not excluded." But McIntyre said that only in an early summary judgment affidavit for Faggen, and Faggen never brought him to trial to repeat it. McIntyre's personal notes, including the selling memo, said just the opposite, and he conceded not having these documents when he signed the affidavit Faggen's counsel supplied (1374-1376, 1445, 1432, 1454-1455).

Faggen's argument that because the Board, sitting in a meeting, were not each given copies of the selling memo, they did not rely upon it, is all too simplistic an approach to corporate reliance. Frank testified that he used the memo to explain each aspect of Faggen's business, "principally using for those specifics [of the transaction] the Exhibit 3 [the selling memo]" (238). Chairman Robinson, President Frank and Treasurer McIntyre studied the selling memo and they were all directors too, and members of the Executive Committee. Director Hegy also read the memo, and as outlined at page 49 of F. Br., the recollection

of the represented earnings was more than $550,000 for every other director who did not have the selling memo, except for Grunebaum, who unsure of his recollection said $450,000 to $500,000 (588). Faggen himself now concedes Kaufman and Frank were looking for "more than" $500,000 (p. 9, F. Br., 981), and Kaufman had the Diebold memo (never disavowed by Faggen) and knowledge of the selling memo figures (141, 143-144). Somehow Faggen feels that if he can separate other board members from its dominant members, who were also officers and had the selling memo, he has eliminated proof of reliance. Faggen urges that leaving final closing up to the Executive Committee, also composed of Robinson, Frank, McIntyre and Grunebaum somehow meant there was no reliance by the same people when they voted a few weeks earlier as part of a board. Page 50 F. Br. then attempts to place reliance responsibility on "appellant's staff and counsel." Appellant's staff was director-house accountant McIntyre, house accountant Russo and director-president Frank, all of whom had the selling memo (annotated "without investment income"), and Titan's counsel was Chairman Robinson who had the annotated selling memo too, plus the projection showing $790,000 in earnings by 1970.* Though reliance need not have been proven, it was established by overwhelming evidence. In a public corporation like Titan, it is 8,000 shareholders who relied on Faggen's accounting presentation. They depend on their officers to obtain information from an acquiree which justifies the $5.5 million in Notes being paid. If there was deception of any of the key agents of the corporation, regardless of the means used, the deception is nonetheless culpable. Public shareholders are no different than buyers in the public marketplace misled by earnings announcements from which material facts are omitted. Intervening agents receive and sift the figures, but ultimately the acquisition shortchanged

* Faggen's 10-year projection (p. 19, T. Br.) is a classic example of precise statement, without reasonable foundation, compounding the deception.

the gullible public, not Robinson or McIntyre who went on to other clients and other jobs. Faggen does not have standing to claim Robinson, Frank and McIntyre were too trusting. Congressional intent on protecting the real investors in Faggen's companies must be carried out by "resolving doubts in favor of those the statute is designed to protect" *Chris-Craft Industries, supra.* 480 F.2d at 375.

On Robinson's role, Faggen incorrectly says (p. 33) that Titan conceded this was not a 10b-5 claim. Titan said Robinson's relationship with Faggen was but "one of the elements here that goes into the background of these contracts" (93). Obviously, the other elements had to be brought out. Faggen's description (p. 34, F. Br.) of facts known about the Robinson relationship falls far short of the real estate partnerships, referral of substantial retainers and numerous lawyer-client matters detailed in T. Br. p. 42. *Shell* v. *Hensley,* 430 F. 2d 819, 827 (5th Cir., 1970), has not been distinguished.

5. *Faggen's Inapposite Authorities.* Faggen says *Gerstle* v. *Gamble-Skogmo, Inc.,* 478 F. 2d 1281 (2d Cir., 1973), requires proof on materiality that plaintiff *would* not have entered the transaction but for the misleading statement, but instead, the case says (478 F. 2d at 1302) "would a reasonable man attach importance to the facts omitted?" Kaufman said: ". . . My conversations with Mr. Faggen . . . looking toward the acquisition . . . was always on the assumption . . . that the company was growing, was adding clients, . . . and that they had no problem whatsoever with the loss of any accounts" (165). Frank testified to the discussions with Faggen on "140 clients or so" and lost clients did not come up (280); "I stated [to Titan's board on October 9, 1968] that I had been told that there were new clients, that one major new client had been landed . . . Q. Did you tell the board . . . [or] know anything about losses of clients by the Faggen companies in 1968? A. No (285). "We [Faggen and

Frank] talked about the business substance from the start, what business he was in, where it was leading, what could be done with it'' (275). We ask what more a buyer of securities needs to show on the substantive importance of certain facts to its executives? And finally when earnings or their shrinkage are in issue, a discrepancy ''at all substantial, *has to be material* to the person being misled." *Republic Technology, supra,* at p. 550. Faggen's citation from the lower court's opinion in *Ply-Gem Industries, Inc.* v. *Green,* CCH Fed. Sec. L. Rep. ¶ 94,026 and ¶ 94,705 (2d Cir., 1974) is also inapposite. The *Ply-Gem* case dealt with vague claims, primarily lack of productivity in a plant, as contrasted with a precise four year summary of adjusted income provided herein by the accountant-seller himself.

6. *Scienter.* There were no findings below on scienter, defined as "wilful or reckless disregard for the truth," or "knowing use of a device, scheme or artifice to defraud," *Lanza* v. *Drexel & Co.,* 479 F. 2d 1277, 1306 (2d Cir. 1973). Titan has even met the more rigorous common law standards of scienter. *Herzfeld* v. *Laventhol, Krekstein, etc., supra,* at page 96,006 says: "Laventhol knew that its report was misleading and knew that it would be delivered to and relied upon by investors. Given these facts, surely Laventhol believed that its report would mislead or convey a false impression and thus deceive investors. The requisite [common law] scienter was, therefore, shown. *Ultramares Corp.* v. *Touche,* 255 N. Y. 170, 187 (1931).'' Under the less restrictive Rule 10b-5 standard, ''knowledge of the fact that the figures created a false picture is enough . . . to constitute scienter.'' *Herzfeld, supra,* at page 96,002; *Republic Technology Fund, supra,* at page 551. Accountant Faggen had actual knowledge of his own undisclosed adding machine tapes listing detailed adjustments for four years, and all the other questionable and non-recurring adjustments, plus the lost clients and lack of computer skills. His omissions were all deliberate as well. E.g., he made $40 distinctions in the selling memo (accounting income $35,240

in 1967 and $35,280 in 1968), but ignored $52,000 items of investment income. He refined expense account savings to $37,574, but overlooked a $59,000 vacation plan charge against income. His own actual knowledge and direct personal benefits meet the scienter requirement thus expressed.

4. The $2.3 million windfall to Mr. Faggen, which should be treated as an unenforceable penalty, is effectively conceded by him.

At p. 51-52 of F. Br., Faggen concedes the Notes were worth only $3.2 million.* But the District Court in finding Titan liable turned the $3.2 million value of the original Notes into $5.5 million as of a mere three and a half years after issuance, when they actually fell in market value (p. 65, T. Br.). Faggen's only answer to this is "each party got what he bargained for" (p. 51, F. Br.). Obviously, the $2.3 million addition to value did not come from market appreciation, the conversion privilege or any other substantive factor. It arose solely by operation of a contract provision—the acceleration clause. Faggen says that damages based on present value of a 4% Note would "make a shambles of the world of commerce," because "Courts do not require a purchaser of such an instrument to prove its value in enforcing the debtor's obligation

* Faggen overstates his net assets at closing at several places, saying "almost $2,000,000", after conceding they were $1,632,501 (p. 41, F. Br.), and misstates gross assets of $700,000 without listing liabilities (p. 5) to try and inflate asset value. None of the exaggerated totals come close to $5.5 million, however. Faggen tries to reinstate the "clearly erroneous" conclusion below of a desperate cash bind leading to a payment of $5.5 million (or even $3.2 million) just to receive $1 to 1.3 million in excess liquid net worth. He has no answer to Titan's ignoring its assumed cash bind and keeping the securities portfolio intact from October, 1968 to April 29, 1969 and then setting up accounts to maintain it indefinitely thereafter (262A #73-1345, p. 47 T. Br.). The court below seized upon a fact, $2 to 2.3 million in excess liquid assets and a desperate cash bind, to justify its visceral approach to reliance, but the fact was simply incorrect and so, respectfully, were its views on the law of reliance.

to pay what is promised." But Faggen was not promised $5.5 million in 1972, and he was not a purchaser of the instrument—he is *not* part of the buyers and sellers of debt securities who rely on the holder in due course concept of the Uniform Commercial Code (see discussion pp. 54-55 T. Br.). Faggen is an original party to the transaction, merely a promisee subject to defenses and *equities* in the underlying transaction. The unanswered line of cases refusing to enforce acceleration clauses that exact a penalty has not created any commercial shambles. See p. 56-61, T. Br. which deals with all of Faggen's contentions on this point. The argument that allowing default on a debt obligation enables a debtor to avoid agreed premiums for redemption is also unsound (p. 54* F. Br.). Wilful default to evade a redemption premium would always be prevented by the courts, but here it is Faggen forcing the redemption, not Titan. He wants full principal paid now, rather than over its term at 4%. Faggen says the 1934 Act does not provide a moratorium on debts, but if this action was brought in good faith, as the record shows and the District Court stated (1189-1190), the law has its customary remedies for the "moratorium" implicit when any contract litigation is in process: Specific performance—payment of the notes as they come due—with interest on late interest (principal is still not due). Alternatively, traditional contract damages (which Faggen preferred) plus interest for delayed payments (see p. 64-66 T. Br.) is the usual remedy. Mr. Faggen wants more than was due, as a result of litigation. Creditors are not supposed to double their money because a debtor disputes their claim. At bottom, Titan did not default, it went to court and relied on a court order saying it did not have to pay the interest installments while it litigated. Acceleration clauses are not enforced when they exact a penalty, and a $2.3 million unearned return on investment is clearly a penalty herein.

Titan Should Also Be Given the Right to Prove Set-offs. Faggen urges (p. 54 F. Br.) that Titan could have the right

to prove other damages only if it prevailed, but if Faggen prevailed his rights were automatic, unimpaired by traditional concepts of set-off or other damage issues. Titan always intended to separately prove that it also owed Faggen even less than the present value of the Notes, because he diverted away the clients of the business he sold. Faggen's brief tries to jumble this set-off issue together with the issue of present value of the Notes by misquoting the record. Titan's request (1185) to prove fair market value of the Notes was now less than $3.2 million arose because Faggen himself proved they were worth only $3.2 million (in 1968) during the liability trial, necessarily impairing his claim for $5.5 million. Titan always planned to put on several expert witnesses, if it prevailed on liability, to show a reduced principal amount of notes were worth about 60% on issuance date and 40-50% by trial date, and the same rule applied to the full principal amount. But right after summation on liability the Court came down with judgment of $5.5 million plus interest, read its findings into the record and didn't give Titan a chance to brief and prove this point. *"The Court:* I don't want any briefs. I was told that you wanted this case tried . . . (1184)."

The set-off against the $3.2 million was not an afterthought and (p. 62-63 T. Br.) was in every document filed from 1972 onward, a motion to amend Titan's complaint,* its brief to the Court of Appeals, in depositions, in its pre-trial proposed findings, and repeated several times at trial and in post-trial motions after dismissal of the fraud claim. The set-offs were not tendered during the liability trial because to do so would have varied the agreed trial format of liability first, damages second. Faggen misquotes Titan in claiming a concession that it owed Faggen two million dollars (p. 57 F. Br.); (1239) says, "We always

* Amending the reply which Faggen urges as the remedy instead, would make a $1,000,000 claim for diverting clients turn on the title of a pleading.

owed him something. We always owed him two million dollars. That was conceded in the papers. The question is, after you are finished on liability, *how much did we owe him, and it was subject to setoff"*. Set-offs were always reserved in further reduction of the liability amount. Faggen misquotes again saying Titan conceded "that the trial court did not cut him off on those issues and was 'very fair' " (p. 56 F. Br.). The two issues thus referred to where the Court let Titan complete its record were only the loss of clients and Robinson's role, not the set-off for diversion of clients (1230-1231). Faggen's authorities on the binding effect of trial strategy are all irrelevant to a trial with liability tried first and damages second. There was no surprise to Faggen in the set-offs and only Titan was surprised, at being cut-off from proof of damage issues (1233).

Conclusion

The judgment should be reversed, and the relief requested in the Conclusion at p. 67 T. Br. should be granted.

September 27, 1974.

Respectfully submitted,

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Due and timely service of Two copies
of the within Brief is hereby
admitted this 30th day of September 1975

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Attorney for Appellant